No. 10289.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

LOMBARD TRUSTEES, LTD., a Trust, and CHARLES S. LOMBARD, BERTHA M. LOMBARD and NORMAN M. LOMBARD, Trustees thereof,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITIONER'S REPLY BRIEF.

UPON PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES.

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In his brief respondent contends

(a) The activities of the trustees established a business purpose;

(b) The trust should be taxed as a corporation prior to March 14, 1937, because "corporate forms" were employed or because of "resemblance" to a corporation;

(c) The trustees constituted the "association". (At least prior to March 14, 1937, the trustees were the association. Whether the trustees or the beneficiaries or all constituted the association thereafter is not discussed.)

(d) The purpose of the Lombard trust can be established only by the provisions of the trust declaration.

Business Activities.

Certainly the activities of the trustees in renting buildings and farming orchards received from Dr. Lombard constituted "doing business", as such term is frequently used. But such activities do not disclose a "business" purpose or require the trust to be classified as an association. The trustees did here exactly what the trustees of a pure trust would have done and exactly what the trustees did in 1939 after this trust was amended so that it followed "the form of a traditional trust." [T. 70.]

There are cases in which the activities of the trustees have evidentiary value in determining the purpose of the associates. Suppose several persons contributed funds or property to trustees in trust. If the trustees used the funds or property for a community hospital or a church, their activities would imply the trust was not for business purposes, but if the trustees used the funds or property for drilling an oil well, a different conclusion would be warranted. If a business purpose be shown in other ways, then the activities of the trustees here would justify classifying the trust as an association.

Resemblance to a Corporation.

It is high time the courts settled the misconception concerning the significance of "corporate form" and "resemblance to a corporation" in the case of a trust.

Every trust, whether classified for taxation as "traditional" or "association", has points of resemblance to a corporation. Every thing that the Supreme Court noted in *Morrissey v. Commissioner*, 296 U. S. 344, as "salient features . . . which may be regarded as making it

(a trust) analogous to a corporate organization" are found in traditional trusts, as the Supreme Court well recognized.

Congress provided for taxing trusts and also provided for taxing associations, which latter were grouped with corporations. What philosophy, theory or reasoning would justify classifying as an association rather than as a trust an organization that had been known as a trust for half a century? In the *Morrissey* case, the Supreme Court reasoned that as a trust had many features found in corporations, when one was "created and maintained as a medium for carrying on of a business enterprise and sharing its gains", Congress intended it to be classified as an association for taxation.

The test of whether a *trust* is to be classified as an association is not resemblance to a corporation or use of corporate forms. Nothing could result in greater confusion. The cases have established that a trust created and maintained for business purposes by a beneficially interested body of persons, will be held to be an association under every circumstance and regardless of whether or not (a) there are one or several trustees; (b) the beneficiaries select or control the trustees; (c) the beneficial interest be divided into shares or evidenced by certificates, or (d) the beneficial interests be transferable.

Whenever it appears the organization involved is in form a trust, it is a waste of words and energy to dwell upon the "corporate form".

At pages 26 and 27, respondent quotes at length the reasoning of the Supreme Court in the *Morrissey* case above referred to and then enumerates eight points of resemblance of the trust involved to a corporation. Each

of these points would also apply to the Lombard Trust after its amendment to the traditional trust form. After such amendment it could also be said (1) the trustees held the legal and equitable title; (2) the trustees constituted a continuing body with provisions for succession; (3) the trust provided opportunity of centralized management; (4) the trustees were charged with management of the enterprise; (5) the trustees were named in the trust instrument; (6) the death of the beneficial owners would not terminate or interrupt the organization; (7) beneficial interests could be transferred (by death) without affecting the continuity of the enterprise; and (8) liability was limited.

In *Porter v. Commissioner*, 130 Fed. (2d) 526, this court announced the tests for determining when a trust was to be held an association. This court did not include resemblance to a corporation. At no place in the *Porter* decision is there any reference to the resemblance theory.

This emphasis upon resemblance in the case of a *trust* is but an intellectual will-o'-the-wisp emanating from a mental morass.

The Trustees of a Business Trust Do Not Constitute an Association.

On page 23 of respondent's brief it is stated that *Hecht v. Malley*, 265 U. S. 144, furnishes a "clear answer" to the question whether the trustees of a business trust are the "associates." That is tantamount to saying *Hecht v. Malley* holds such trustees constitute the association. *Hecht v. Malley* holds nothing of the kind. It establishes the reverse.

That decision was concerned with excise taxes imposed by the revenue laws on "every corporation, joint-stock company or association." Involved were three Massachusetts trusts. Each had shares that were transferable. Each had trustees. Their general nature is shown by the following excerpts:

> "The Hecht Real Estate Trust was established by the members of the Hecht family upon real estate in Boston used for offices and business purposes, which they owned as tenants in common. It is primarily a family affair . . . The Haymarket Trust is strictly a business enterprise. It was established by the original subscribers, who furnished the money for the purchase of a building in Boston, used for store and office purposes. The shares are of the par value of $100 each . . . The Crocker, Burbank & Co. Ass'n is also a business enterprice. It was formerly entitled the Wachusett Realty Trust . . . Since the modification of the trust agreement, the trustees have carried on the manufacturing business in substantially the same manner as it was formerly conducted by the corporation . . . The trustees of Crocker Association . . . admitted in the circuit court of appeals and at the bar, that since the modification of the original trust agreement, the trust constitutes an 'asosciation.'"

The Supreme Court said:

> "The 'Massachusetts trust' is a form of business organization, common in that state, consisting essentially of an arrangement whereby property is conveyed to trustees, in accordance with the terms of an instrument of trust, to be held and managed for the benefit of such persons as may, from time to time, be the holders of *transferable certificates* issued by

the trustees, showing the shares into which the beneficial interest in the property is divided. These certificates, which resemble certificates for shares of stock in a corporation, and are issued and transferred in like manner, entitle the holders to share ratably in the income of the property, and, upon termination of the trust, in the proceeds. . . .

"The word 'association' appears to be used in the act in its ordinary meaning. It has been defined as a term 'used throughout the United States to signify a body of persons united without a charter, but upon the methods and forms used by incorporated bodies for the prosecution of some common enterprise.' 1 Abbott's Law Dict. 101 (1897); 1 Bouvier's Law Dict. Rawle's 3d Rev. p. 269; 3 Am. & Eng. Enc. Law, 2d ed. 162; and Allen v. Stevens, 33 App. Div. 485, 54 N. Y. Supp. 8, 23, in which this definition was cited with approval as being in accord with the common understanding. Other definitions are: 'In the United States, as distinguished from a corporation, a body of persons organized for prosecution of some purpose, without a charter, but having the general form and mode of procedure of a corporation.' Webster's New Int. Dict. '(U. S.) An organized but unchartered body analogous to, but distinguished from a corporation.' (Cases omitted.)

"We think that the word 'association', as used in the act, clearly includes 'Massachusetts trusts' such as those herein involved, having *quasi* corporate organizations under which they are engaged in carrying on business enterprises. What other form of 'associations', if any, it includes, we need not, and do not, determine."

From the foregoing definitions it is apparent to constitute an association there must be an unincorporated

body of persons employing corporate forms. The trustees of a trust correspond to the directors of a corporation. Each provides management. Therefore, when an unincorporated group associated for business entrusts the management of their business to trustees they are employing the form most characteristic of a corporation. But the trustees as such do not constitute the "body of persons."

Relying on *Crocker v. Malley,* 249 U. S. 223, the trustees of two of the trusts contended in *Hecht v. Malley* "that they cannot be held to be 'associations' unless the trust agreements vest the shareholders with such control over the trustees as to constitute them more than strict trusts within the Massachusetts rule."

The Court then reviewed *Crocker v. Malley* in which it was held the trust there involved had the limited purpose of collecting and disbursing income and the beneficiaries had no right of control over the trustees. Under the Massachusetts law the trust involved in the *Crocker* case was a strict trust and the Supreme Court had held the trust was not a joint-stock association so as to make dividends received by the trustees taxable the second time as they would have been if received by a corporation.

The Court in *Hecht v. Malley* concluded the lack of control by beneficiaries would not prevent a trust from being classified as an association under the Act there involved when it was organized for business purposes. In emphasizing the distinction between a trust having a limited purpose such as to collect and pay over funds, as in the *Crocker* case, and one having a general business purpose, the Court referred to the trustees in the trusts there considered as being associated for the purpose of carrying on business enterprises.

Counsel for respondent seize upon the reference to the trustees being "associated" for carrying on business, and assert the Court said the trustees constituted the association. The Court had no such thought in mind. The entire paragraph from which counsel quote a few lines reads as follows:

> "We conclude, therefore, that when the nature of the three trusts here involved is considered, as the petitioners are not merely trustees for collecting funds and paying them over, but are *associated* together in much the same manner as the directors in a corporation for the purpose of carrying on business enterprises, the trusts are to be deemed associations within the meaning of the Act of 1918; this being true independently of the large measure of control exercised by the beneficiaries in the Hecht and Haymarket cases, which much exceeds that exercised by the beneficiaries under the Wachusett Trust. We do not believe that it was intended that organizations of this character—described as 'associations' by the Massachusetts statutes, and subject to duties and liabilities as such—should be exempt from the excise tax on the privilege of carrying on their business merely because such a slight measure of control may be vested in the beneficiaries that they might be deemed strict trusts within the rule established by the Massachusetts courts."

Both of these cases (*Crocker v. Malley* and *Hecht v. Malley*) are reviewed at length in *Morrissey v. Commissioner, supra.*

In the *Morrissey* case the Court repeats the definitions of an association given in *Hecht v. Malley,* which refer to an association as "a body of persons" and "an organized

but unchartered body." The Court adds emphasis to these definitions by stating " 'Association' implies *associates*. It implies the entering into a *joint* enterprise." Then the Court passes upon the facts presented in the *Morrissey* case where the beneficial interest was evidenced by 2,000 transferable shares held by several hundred persons. It says:

> "Thus those who took beneficial interests became shareholders in the common undertaking to be conducted for their profit according to the terms of the arrangement. They were not the less associated in that undertaking because the arrangement vested the management and control in the trustees. And the contemplated development of the tract of land held at the outset, even if other properties were not acquired, involved what was essentially a business enterprise."

The opinions in the *Morrissey* and three companion cases were handed down December 16, 1935. They were written by Chief Justice Hughes. He further disclosed his concept of an association by declaring in one of them (*Helvering v. Coleman-Gilbert Associates*, 296 U. S. 369): "A few persons, as well as many, may form an association to conduct a business *for their common profit*."

The contention that the trustees may constitute an association was considered and rejected by the Supreme Court in *Crocker v. Malley, supra*. It also rejected the contention that the trustees and the beneficiaries constituted an association. It said,

> "the trustees by themselves cannot be a joint-stock association within the meaning of the act unless all trustees with discretionary powers are such . . .

> We perceive no ground for grouping the two—beneficiaries and trustees—together in order to turn them into an association by uniting their contrasted functions and powers, although they are in no proper sense associated."

In *Hecht v. Malley,* the Court quoted the above and must have had it in mind in defining an association to be a body of persons united for the prosecution of some common enterprise. There can be no question but the Supreme Court in the *Hecht* case conceived the "body of persons" to be the beneficiaries and not the trustees.

Also, in the *Morrissey* case, the Supreme Court must have had in mind the question whether the trustees or the beneficiaries constitute the association, for it is declared the *Crocker* case decided:

> "Nor could the trustees 'by themselves' be treated as a joint-stock association within the meaning of the Act 'unless all trustees with discretionary powers are such."

One of the most lucid expositions of the law bearing generally and specifically upon this case appears in the opinion of District Judge Tuttle in *Davidson v. U. S.,* Dec. 23, 1938, U. S. D. C., E. D. Mich., 24 Am. F. T. R. 118, affirmed 115 F. (2d) 799. Judge Tuttle said:

> "The nearest approach to a general test appears to be the requirements that in order to constitute an association, taxable as such, there must be a number of persons (associates) entering into a joint enterprise for the transaction of business. The courts have emphasized the general points of resemblance between all trusts and all corporations, not as holding that all trusts are associations, but as explaining the

case with which the trust form can be used by associates in forming an enterprise for the transaction of business, and as justifying the subordination of form to substance in such cases. This Court is not convinced, however, that the mere points of resemblance referred to by the Supreme Court in Morrissey v. Commissioner, 296 U. S. 344, and strongly relied upon by the Government in this case, are to be considered as branding as an association, every trust in which those characteristics are found. If so, few or no trusts would be exempt. These characteristics were mentioned by the court in the Morrissey case as making a trust analogous to a corporate organization, and as justifying its taxation as such, if and when (but only if and when) these features common to both organizations have been used and adapted by persons joining in a common enterprise for the transaction of business."

Tax Statutes Cannot be Extended by Implication Beyond Their Clear Import and in Case of Doubt Are Construed Against the Government.

Considerable of respondent's argument appears bottomed on a contention there ought to be no distinction between a trust with one beneficiary and a trust of the same provisions with two or more beneficiaries.

Thus, respondent writes:

"Here is an organization which lacks only a charter to be a corporation, for corporations with but one stockholder are common . . . Even if counsel's contention is sound that taxpayer is not *technically* an 'association' because it lacks associates, it nevertheless cannot be denied that it is more like a corporation than most entities which have been classed as

> association and accordingly taxed as a corporation. Yet the test of taxability as a corporation is similarity to it. The incongruity can only be resolved by a pragmatic application of the association concept." (B. 29, 30, 31.)

The answer to respondent's contention is that Congress in its infinite wisdom has seen fit to provide otherwise. From the *Hecht v. Malley* decision in 1923 down to the present time, the courts have repeatedly declared that an association was, under the income tax law, "a *body of persons* united without a charter, but upon the methods and forms used by incorporated bodies for the prosecution of some *common* enterprise." Every definition and every decision has shown there must be a plurality of beneficiaries before there might be an association. All regulations have been harmonious. As Congress in the light of such definitions and regulations reenacted in every Act the provision "The term 'corporation' includes associations, joint-stock companies and insurance companies," it must have been satisfied with the concept of an association as declared by the courts.

Respondent would change the definition to read:

> "An association is a body of persons or a person who without being incorporated, uses the methods and forms of incorporated bodies for the prosecution of their or his business."

The result desired by respondent might be obtained only by extending the plain and accepted meaning of the term "association." That may not be done. In *United States v. Merriam,* 263 U. S. 179, 187, the Supreme Court said:

> "On behalf of the government it is urged that taxation is a practical matter, and concerns itself with

the substance of the thing upon which the tax is imposed, rather than with legal forms or expressions. But in statutes levying taxes the literal meaning of the words employed is most important, for such statutes are not to be extended by implication beyond the clear import of the language used. If the words are doubtful, the doubt must be resolved against the government and in favor of the taxpayer. Gould v. Gould, 245 U. S. 151, 153, 62 L. Ed. 211, 213, 38 Sup. Ct. Rep. 53. The rule is stated by Lord Cairns in Partington v. Atty. Gen., L. R. 4 H. L. 100, 122.

"I am not at all sure that in a case of this kind —a fiscal case—form is not amply sufficient; because, as I understand the principle of all fiscal legislation, it is this: If the person sought to be taxed comes within the letter of the law, he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible in any statute what is called an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute."

Evidence of Purpose.

In opening, we conceded that if the purpose of the Lombard Trust was formally set forth and appeared in the trust declaration, taxpayer was bound thereby and might not show a different purpose. We declared there was no formal or other statement of purpose in the trust declaration; that only inferences and conjectures might be drawn from the trust declaration and these were equivo-

cal; that the Board committed prejudicial error when it ruled it could not "go outside the terms of the agreement" and refused to consider all of the evidence. This presents a question that was not presented, considered or decided in the *Porter* case.

Respondent writes:

> "The Board's finding of a business purpose was based on the general purpose stated in the 'Plan', the broad powers given to the taxpayer and its business activities." (B. 15.)

Respondent does not call attention to provisions in the declaration revealing the "general purpose" nor have we been able to discover any. We are aware of provisions conferring broad powers upon the trustees but these are hardly broader than the powers conferred in most testamentary trusts. Among such *powers,* and so labeled, it is stated the trustees

> "may engage the Estate funds and properties in any industry or investment in their discretion, hoping thereby to make gain to the Estate." [T. 28.]

(We think trustees ought to be removed forthright if they invested the estate funds and properties hoping thereby to make a *loss* to the estate.)

In trusts there is as great a difference between purposes and powers as there is in nature between night and day. If powers are to be held equivalent to purposes in trusts, or if purposes are to be inferred or deduced from the powers conferred upon the trustees, then practically every testamentary trust must be held a business trust and taxed accordingly.

The provisions noted are appropriate for a business trust, but they would not be inappropriate for a strict

trust. If the declaration had stated that the trustees were to engage the funds for profit, or the purpose was to engage the funds for profit, these lines would not be written.

Courts have frequently repeated the dogma "the parties are not at liberty to say that their purpose was other or narrower than that which they formally set forth in the instrument under which their activities were conducted." After making the quoted statement, the courts have invariably proceeded to consider evidence dehors the declaration to ascertain the purpose of the trust. The Board did that. Respondent follows.

If the quoted declaration means what respondent contends, then the trust declaration here should be taken by its four corners and considered. If the only evidence of purpose which may be considered is that which appears there, then stop there. In so doing, it will appear that Dr. Lombard is the sole beneficiary.

When the respondent refers to Dr. Lombard's intention later to take in others, or to use the trust for the benefit of his family, respondent is definitely not applying the rule for which respondent argues. Respondent is then endeavoring to prove Dr. Lombard had a purpose that does not appear in the declaration.

Miscellaneous.

(a) *A beneficiary was provided for and named in the trust declaration.* In opening, we directed attention to the stipulation that the instructions directing expectancy fractions to be registered in Dr. Lombard's name was executed with the other instruments "as a part of and to evidence a single transaction and agreement." [T. 9.] We

said a beneficiary or *cestui que* trust was provided for and named in the trust declaration and the Board was mistaken in declaring the contrary. The Board's erroneous statement is repeated at page 6 of respondent's brief and on page 23 respondent writes, "Thus, at the outset there were five individuals involved in the organization—two grantors and three trustees and *no beneficiaries.*" We assume the plural form has been used advisedly. At the outset there were no beneficiaries but there was one beneficiary.

(b) *The beneficial interests were not fully transferable.* The only transfer referred to in the "Contract Containing Articles of Administration" is one in event of death of a beneficiary. [T. 33.] Standing alone, it may be doubted that provision would have prevented voluntary transfer. But in the instructions which were a part of the agreement, transfer is expressly restricted and, expressed in specific terms, no transfer could be made by a beneficiary other than Dr. Lombard without his "positive written instruction." [T. 39.] When respondent writes "Beneficial interests can be transferred without affecting the continuity of the enterprise" (B. 28, 29), respondent is correct, but one should not fall into the error of assuming the beneficial interests were freely transferable as are shares of a corporation. We think the question of transferability unimportant. If it be important, then it may be noted this trust has always lacked one of the most characteristic and distinguishing features of a corporation. Rather, in this particular, the trust is more like most testamentary trusts.

(c) *Title of the Trustees.* On page 28, respondent declares the trust instruments state the legal and equitable

interest is in the trustees. At no place do we find that statement. The trust declaration does declare that the legal and equitable *title* to the property held by the trustees is in the trustees. We think this phase unimportant. However, there may be a distinction between equitable interest and equitable title. The terms "equitable interest," "equitable estate," "beneficial interest" and "beneficial estate" are generally used as equivalent, and all have been applied to the interest of a beneficiary under a trust. In Restatement, the beneficiary is referred to as having an equitable *interest* in the subject matter of the trust. Such interest might also have been called the "beneficial *interest*." But equitable *title* is most commonly defined as a right in the party to whom it belongs to have the legal *title* transferred to him. (20 *C. J.* 1304.)

The beneficiary of an express trust, while having a beneficial interest in the subject matter of the trust, certainly does not ordinarily have any right to have the legal title conveyed to him. In the case of a resulting trust or constructive trust, it might with more exactness be said the beneficiary has an equitable *title*.

Title Insurance & Trust Co. v. Duffill (1923), 191 Cal. 629, referred to by respondent is merely one of numerous cases in which the interest of a beneficiary is referred to as the "equitable estate" or "beneficial interest." The California Supreme Court, in bank, in *Estate of Troy* (1931), 214 Cal. 53, said:

> "It may be taken as settled by the decisions in this state that the beneficiary of a trust takes no estate in the property itself and that title vests in the trustee with the right in the beneficiary to enforce performance of the trust."

Respondent appears to contend that the trustees here took a greater title than the trustees of a trust; therefore, says respondent, this cannot be a trust; rather, it is unclassified and unnamed thing unknown to the law that looks like a corporation but breathes and acts like a trust. But it is not a corporation. Then what is it? If Dr. Lombard's grantees did not take title for the benefit of another person or persons (thereby making a trust), they must have taken title absolutely, in the sense that the full beneficial interest and use was theirs. If so, they held the property as partners and were taxable as individuals.

(d) *Massachusetts Trusts.* In a foot note on page 30, respondent writes:

> "It requires no citation of authority to establish that 'Massachusetts Trusts', which Regulations 94, Article 1001-2 expressly provides are taxable as corporations, need have only one beneficiary."

We challenge that statement as promptly and as assuredly as a policeman would challenge a stranger climbing from a window with a child's piggy bank.

When two or more beneficially interested persons associate for business purposes, employing a trust form, and are engaged in such business, they constitute an association within the tax law. But when one beneficially interested person causes his property to be held and managed in trust form by another or others called "trustees," there is no association for tax purposes, and it cannot be made an association for tax purposes by pinning a label on it.

We think the term "Massachusetts Trust" does not have an exact meaning. If, however, the definition in

Hecht v. Malley be accepted, then the trust here involved was not a Massachusetts Trust as there were no transferable certificates.

(e) *Section 166 of 1936 Revenue Act.* We think respondent misunderstood us. Any trust is taxable as a corporation during any time it is legally an "association." If the trust in the instant case was not an association prior to March 14, 1937, then the trust is not to be taxed as a corporation on income prior to March 14, 1937. Rather, such income is taxable to Dr. Lombard under Section 166 of 1936 Revenue Act. It might further be added, it would also be taxable to Dr. Lombard under Section 167 of said Act.

(f) *Those Becoming Beneficiaries.* On page 24, respondent quotes from the *Morrissey* case the Court's remarks about those who subsequently become beneficiaries. Respondent says the Court "emphasizes that the entity is an association regardless of whether the beneficiaries come into the enterprise at the outset or come in later according to the terms of the arrangement." This doesn't deserve comment so none will be made except to remark that litigation, like war, frequently results in scarcity.

(g) *Changing Times.* In former days, reference was often made to the use of the trust for business to avoid corporation taxes. The adjusted income from the trust property for 1937 amounted to $22,902.04. At the rates in effect as this is written, the income tax on that amount at corporate rates would be $6,141.59 and at rates applicable to trusts, allowing the $100 trust deduction, would be $8,870.18. Times have changed. The courts should not be surprised in the new cases to find the positions of the parties have also changed.

(h) *Adjudication of All Questions.* If the Court holds the trust first became an association when others became beneficially interested with Dr. Lombard, it will be necessary to determine from what date in 1937 the income is includible, whether February 10, 1937 or March 14, 1937. After March 14, 1937, the sum of $1,868.96 was received as the balance of the purchase price of the orange crop sold on February 23, 1937. We contended Dr. Lombard might not relieve himself from returning and accounting for that item by transferring it. In his brief, respondent has not questioned or disputed our contention on these phases. However, should the case be returned to the Tax Court, respondent may resume his original position and claim the date of demarcation was February 10, 1937, and the year's income should be apportioned. The questions were fully presented to the Tax Court. It failed to decide them as it held there was an association from 1935 on. There should be a directive from this Court to the Tax Court on these questions in order to end the litigation.

Respectfully submitted,

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